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# Irresistible Forces and Political Obstacles: Securities Litigation Reform and the Structural Regulation of Corporate Governance

John W. Cioffi

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John W. Cioffi

**Irresistible Forces and Political Obstacles:  
Securities Litigation Reform and the Structural  
Regulation of Corporate Governance**

Sarbanes-Oxley, enforcement, private litigation, regulation

Department of Political Science, Watkins Hall  
University of California, Riverside, 92521  
Phone: (951) 827-7269  
Email: john.cioffi@ucr.edu

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Keywords: *Sarbanes-Oxley*, enforcement, private litigation, regulation

Author Contact:  
Department of Political Science, Watkins Hall  
University of California, Riverside, 92521  
Phone: (951) 827-7269  
Email: john.cioffi@ucr.edu



# IRRESISTIBLE FORCES AND POLITICAL OBSTACLES: SECURITIES LITIGATION REFORM AND THE STRUCTURAL REGULATION OF CORPORATE GOVERNANCE

John W. Cioffi<sup>\*</sup>

Congress passed the *Sarbanes-Oxley Act of 2002* in reaction to the enormous political pressures generated by the wave of corporate financial scandals during 2001-2002. The Act's innovative reforms of corporate governance law were shaped by powerful political constraints on the use of private litigation and tensions over the use of "structural regulation" to alter the *internal* governance structures and procedures of publicly traded corporations. The conservative political realignment during 1990s precluded the development or expansion of litigious enforcement mechanisms (i.e., private causes of action) to curb corporate and managerial financial misconduct. Consequently, a number of the *Sarbanes-Oxley Act's* core provisions took the form of structural regulation intended to function as non-litigious, self-executing mechanisms of regulation. Political constraints on the use of private litigation as an enforcement mechanism entailed a more direct intervention of state power within the corporation and blurred the established boundaries between the public and private spheres. However, the legislative reforms did not alter the core processes of corporate

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<sup>\*</sup> Assistant Professor of Political Science, University of California, Riverside. Contact information: Department of Political Science, Watkins Hall, University of California, Riverside, 92521, phone: (951) 827-7269, email: john.cioffi@ucr.edu. I would like to thank Neil Fligstein, Peter Gourevitch, Darius Gaskins, Bob Kagan, Mark Landy, Bronwyn Leebaw, Martin Levin, Jonathan Macey, Ulrike Schaede, Peter Schuck, Martin Shapiro, Steven Teles, Steven Vogel, Graham Wilson, and Nick Ziegler for their comments and encouragement. I would also like to thank Bill Frenzel and Pietro Nivola of the Brookings Institution and Thomas Richardson, Esq. of Arnold & Porter for their help in facilitating research for this article. All remaining errors are my own. I would also like to thank the Academic Senate of the University of California, Riverside and the Gordon Public Policy Center at Brandeis University for financial support for this research.

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## I. INTRODUCTION

The *Sarbanes-Oxley Act of 2002*<sup>1</sup> was the most significant reform of American securities and corporate governance law since the New Deal. The reforms are part of a long history of political struggle over the form, power, and legitimacy of the corporation and financial capital. Yet the *Sarbanes-Oxley Act* also represents a sharp break with nearly two centuries of American federalism and established forms of corporate governance regulation. The central puzzle of American corporate governance reform is how and why Congress passed such significant reform during a politically conservative era in which corporate and managerial power were at a zenith, and why it took such a novel form. The answer to both parts of the puzzle is contextually and historically contingent. First, extraordinary conditions of stock market crashes and corporate financial scandals temporarily disrupted interest group politics and partisan divisions to allow substantial legal and institutional change. Second, political constraints on the use of litigation as a means of addressing managerial financial fraud and abuse impelled legislators to embrace alternative mechanisms of regulation as part of the reforms. Financial crisis and political constraints provided the conditions for regulatory innovation.

As forged by post-New Deal regulatory politics and the post-war liberal legalism of the 1960s and 1970s, regulation in the United

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<sup>1</sup> Public Company Accounting Reform and Investor Protection (Sarbanes-Oxley) Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as scattered sections of 11, 15 18, 28 and 29 U.S.C.). Passed by both the House and Senate on July 25, 2002; signed into law by President George W. Bush on July 30, 2002.

States is typically highly prescriptive and litigious. Institutionally fractured by federalism and the separation of powers, shot through with multiple veto points, and lacking the more autonomous administrative bureaucracies and neo-corporatist bargaining arrangements common in many advanced industrial countries, the United States developed a distinctive form of legalistic regulation (Kagan, 2001; Keleman, 2004; Cioffi, 2004b). Regulatory politics has tended to produce detailed prescriptive rules and enforcement through private litigation. This form of legal ordering constitutes the private sphere as a broad zone of presumptive autonomy for economic actors and defines their relations as predominantly those among private parties enforcing private rights through litigation. Yet in recent years, political conflict over the scope, role, and litigious means of enforcing regulatory norms has grown increasingly intense.

The internal structure and governance of the corporation in the United States has long been defined by detailed prescriptive transparency and disclosure regulation under federal securities law, as well as minimal mandatory legal requirements concerning the internal form and operation of the firm under state corporation law (Cioffi, 2004a, 2004b). This established pattern began to change with the federal corporate governance reforms that followed the wave of financial scandals that began with the collapse of Enron in 2001. Political theories of regulation would predict either that the veto-prone political structure of the United States would have allowed powerful interest groups to block significant legal and regulatory reforms (*cf.* Tsebelis, 1995) or, alternatively, that reforms would remain within the established trajectory of increasingly detailed prescriptive (or proscriptive) legal rules reinforced by additional litigation-driven remedies (Kagan, 2001). Alternative theories of regulation and economic governance proposed by a number of scholars may anticipate new forms of law and regulation but do not adequately address the political dynamics capable of producing such regulatory



innovations.<sup>2</sup> This article takes issue with both general theoretical perspectives.

Significant reforms *did* follow in the wake of the post-Enron corporate governance crisis but they *did not* expand or create new avenues for litigation. Instead, many of the reforms passed by Congress in the *Sarbanes-Oxley Act of 2002* and those later adopted by the Securities and Exchange Commission took a strikingly different path—one that I label *structural regulation*, through the restructuring of institutional and organizational arrangements within the private sphere to effect policy goals of improved corporate governance, managerial accountability, and financial market legitimacy. This article analyzes how and why corporate governance reform in the United States overrode interest group and partisan politics, departed from the established forms and federalist patterns of regulation, and remained cabined by political constraints that may limit the effectiveness of regulatory innovations.

Congress passed the *Sarbanes-Oxley Act of 2002* in response to the collapse of the American stock markets and the subsequent wave of corporate financial scandals during 2001-2002. The stock market crashes, dot.com failures, the seemingly endless disclosures of financial fraud and manipulation accompanied by the largest corporate collapses in American history, represented massive failures of market, corporate, and regulatory institutions. A crisis of investor confidence and, ultimately, of the broader legitimacy of the American political economic order compelled

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<sup>2</sup> There are a wide array of such re-conceptualizations of regulation and the regulatory state. *See*, for example, Teubner, 1983 ("reflexive law"); Stewart, 1986 ("reconstitutive law"); Ayres & Braithwaite, 1992 ("responsive regulation"); Freeman, 1997 ("collaborative governance"); Krawiec, 2003 ("negotiated governance"). Each in its own way seeks to address the rigidities, inefficiencies, conflicts, and other undesirable attributes of regulation in an advanced industrial political economy, yet they do not describe how law and regulatory politics characteristically work in the United States.

Congress to act quickly to pass reform legislation that could never have been passed under ordinary conditions.

The regulatory innovations of the *Sarbanes-Oxley* reforms were shaped by powerful political constraints on the use of private litigation to curb managerial financial misconduct. During the mid-1990s, hostility towards litigation as a mechanism of legal and regulatory enforcement culminated in the passage of federal securities litigation reform laws and since then has become an entrenched feature of federal legislative politics. Given the political constraints on using private litigation, congressional proponents of reform could not use traditional litigious mechanisms of enforcement to protect shareholder interests. Instead, they pursued an incremental *federalization of the structural components of corporate law* as the favored mode of regulatory reform. As a result, the *Sarbanes-Oxley* corporate governance legislation employed mechanisms of *structural regulation* that work by altering the institutional structure and internal functioning of the corporate form and board of directors, rather than rules enforceable through private litigation. These structural alterations of the corporation were designed to curb managerial abuses through non-litigious, self-executing mechanisms of regulation. *Sarbanes-Oxley* federalized core features of corporate law that had long been the province of the states. In doing so, the reforms' use of structural regulation revealed the constitutive force of the public sphere, through law and regulation, on the ostensibly private sphere of the corporation.

The exigencies of post-1990s corporate governance reform and the political legacy of anti-litigation politics of the 1990s produced a paradox: the political constraints on the use of litigious enforcement mechanisms led to an even more extensive and intensive forms of governmental regulatory power over corporate affairs. The inability to use private litigation as an enforcement mechanism resulted in the *Sarbanes-Oxley Act's* path-breaking expansion of federal authority over the internal structure and affairs of the corporation and a more direct intrusion of governmental power into what had been largely regarded as the

autonomous private sphere of the corporate firm. Ultimately, this encroachment on the institutional bases of managerial power and autonomy, and attempts to build upon it by the Securities and Exchange Commission, prompted a backlash by business against further reforms and against portions of *Sarbanes-Oxley* itself.

This article examines the vacillations of American securities regulation from the mid-1990s through the enactment of the *Sarbanes-Oxley Act* in 2002. There are three basic findings: (1) under conditions of severe and persistent market failures *state actors marshaled the political forces driving reform to increase regulatory intervention in the private sphere*; (2) *clashing partisan political agendas induced the form of corporate governance regulation towards structural regulation*; and (3) *the failure to alter the way in which directors are nominated and elected reflected the limits of structural reform and regulation* under the prevailing conditions of American politics and economic organization. These findings are supported by an analysis of successive waves of “backlash” politics, in which legislators and partisan coalitions seize the initiative before the veto-prone logjam of pluralistic American politics reasserts itself. This history is presented in three stages. The first covers the politics of securities litigation reform of the mid to late-1990s. The second deals with the legislative and regulatory corporate governance reforms of 2001-2004. The last phase encompasses a growing business backlash against reform and the expanding regulatory intervention in corporate affairs.

## II. ANTECEDENTS OF STRUCTURAL REGULATION IN CORPORATE GOVERNANCE

### A. THE FOUNDATIONS OF CORPORATE CAPITALISM AND THE FEDERALIST LEGACY

Corporation law always had a structural component that instantiated the institutional minima of the corporate form and its governance. This structural framework has inevitably had a

regulatory effect on corporate governance by allocating power and influencing the behavior of stakeholders within the corporation. Over the course of the 19<sup>th</sup> and 20<sup>th</sup> Centuries, the structural and fiduciary elements of corporation law became less restrictive and increasingly ineffective in constraining managerial and corporate actions. Yet as the federal government established a national framework of securities law and regulation, the core functions of state corporation law in defining the basic corporate governance structures and fiduciary duties of directors and officers remained intact. Federalism in corporate governance law remained surprisingly stable during a long era of federal government expansion and regulatory centralization.

Corporation law has always provided for the minimum structural features and requirements of corporate governance. Within the constraints of state corporation law, corporate charters established the business purposes of the corporation, created the classes of stock, and defined shareholder voting rights and procedures. In the 19<sup>th</sup> Century, prior to development of modern securities law, corporate law was virtually the only body of law governing corporate affairs and protecting investors. The powers granted to the corporate firm and their structural allocation within it under state corporate law constrained managerial behavior. In particular, state law restrictions on the corporate ownership of stock impeded mergers and acquisitions. New Jersey and then Delaware adopted more *laissez faire* corporation laws which triggered a swift erosion of these restrictions on corporate capacities and managerial conduct nationwide. This liberalizing "Delaware effect" facilitated the first great merger boom in American history at the end of the 19<sup>th</sup> Century and shaped the form of managerial capitalism that would characterize the United States for a century. However, as the strictures of corporation law loosened, the scale of enterprises grew more massive, and the separation of ownership from corporate control became ever more apparent, the legitimacy of the new managerialism became the focus of intensifying political debate from the Progressive Era through the New Deal.

Proposals to federalize corporate law as a means of eliminating the “Delaware effect” and the resulting “race to the bottom” were debated repeatedly during the late 19<sup>th</sup> and early 20<sup>th</sup> Centuries, but could never overcome the resistance of state officials and constituencies, political conservatives, and managerial elites. This prolonged debate over the legitimacy of corporate capitalism and managerialism culminated with the New Deal, but still did not result in a federal corporation law. Instead, federal legislation and regulation was directed towards financial markets and their regulation that were more clearly national in scope and impact. The *Securities Act of 1933* mandated disclosure standards for initial public offerings of stock on publicly traded markets.<sup>3</sup> The *Securities and Exchange Act of 1934* created a transparency and disclosure regime covering publicly traded stocks after their initial offering and designed primarily to ensure adequate information flowed to investors to strengthen and legitimate securities markets.<sup>4</sup> The 1934 Act also laid the foundations of modern securities regulation by creating the Securities and Exchange Commission, enabling extensive agency rule making, and granting the SEC administrative enforcement powers. Yet the legacy of the old federalist structure remained. The post-New Deal corporate governance regime established a rough division of labor between securities law and state corporation law. The latter for the most part continued to govern the corporation’s internal structure and relationships.<sup>5</sup>

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<sup>3</sup> 15 U.S.C. § 77a-z.

<sup>4</sup> 15 U.S.C. § 78aa-mm.

<sup>5</sup> For example, this division was made explicit in the DC Circuit’s decision in *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990), in which the court ruled that Securities and Exchange Act did not grant the SEC regulatory authority over the internal affairs of listed corporations and held that SEC rules

The New Deal legislation did encroach on one traditional subject of state corporation law. *The Securities and Exchange Act* federalized shareholder proxy voting as part of a broader regulation of corporate (or more realistically, management's) communications with shareholders. This placed control over one of the most structurally sensitive of all corporate governance functions in the hands of federal regulators. However, federal legislation and SEC proxy regulations gave management *de jure* and *de facto* control over the proxy process and thus over the nomination and election of the board of directors. By effectively giving managers the power to choose their ostensible overseers, the federal regime entrenched managerial power and authority within the corporation.

The federal regime contained a number of other structural approaches to securities and corporate governance regulation. The *Investment Company Act of 1940*<sup>6</sup> encroached on traditional state law governing the composition of boards and the qualifications of directors of investment funds. The 1940 Act employed a modest form of structural regulation by prohibiting investment companies, such as mutual funds, from having fewer than forty per cent of its board comprised of independent directors, or a majority of its board comprised of representatives of a single bank.<sup>7</sup> The failure of federal securities law and disclosure regulation to prevent corporate corruption and foreign bribery scandals during

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prohibiting dual class shares with unequal voting rights were beyond the scope of the agency's delegated powers.

<sup>6</sup> 15 U.S.C. §§ 80a-1 through a-64.

<sup>7</sup> 15 U.S.C. § 80a-10. However, "business development companies," essentially publicly traded private equity firms that were exempted from some requirements of the Investment Company Act under a 1980 amendment, must have a *majority* of disinterested directors (those unaffiliated with the company's sponsor and investment adviser). *See* 15 U.S.C. § 80a-55(a). The increase in the required number of independent directors from the original 1940 Act to the 1980 amendments suggests the growing currency of board independence as an alternative form of regulation.

the 1970s resulted in yet another experiment in structural regulation. The *Foreign Corrupt Practices Act of 1977* ostensibly required corporations to adopt internal controls and monitoring procedures to prevent corrupt business practices.<sup>8</sup> Perhaps most importantly, the New York Stock Exchange listing rules, adopted in 1977 under pressure from the SEC, required that the boards of public companies form audit committees comprised entirely of independent directors. The listing rules are particularly important to the politics and regulation of corporate governance in that they have given the SEC a way to gain regulatory leverage over the internal governance of listed firms, otherwise denied it by judicial interpretations of the federal securities laws (*See* Chandler and Strine, 2002: n.12).

Federal proxy voting rules and the *Investment Company Act's* independent director provisions failed to appreciably reallocate power within publicly traded corporations and investment funds. Similarly, the FCPA's internal control and monitoring requirements are widely viewed as ineffective and largely a failure.<sup>9</sup> And the NYSE independent director and audit committee rules had minimal impact on the actual functioning of boards and corporate governance. These nascent forms of structural regulation maintained or replicated the managerialism that had already established itself as a defining characteristic of American corporate capitalism. Structural regulation as a check on managerial power was largely abandoned in favor of prescriptive formal regulation and market reinforcing disclosure rules. This followed an enduring pattern in which the disclosure requirements securities law and regulation largely eclipsed corporation law during most of the New Deal and post-war eras. Financial transparency secured by federal disclosure rules and substantial rates of litigation drove the

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<sup>8</sup> *See* 15 U.S.C. § 78dd-3; 15 U.S.C. § 78(m)(b)(2)-(6).

<sup>9</sup> *See*, e.g., U.S. Senate, 2003 (report detailing failure of federal enforcement officials to pursue IRS warnings of foreign corrupt practices by Enron).

American corporate governance system, rather than the structural or fiduciary features of state corporation law.<sup>10</sup>

This eclipse of state corporation law came to a sudden and dramatic end in the ferocious battles over hostile takeovers during the 1980s. Although tender offers and hostile takeovers emerged during the 1960s and increased in incidence during the 1970s, the dramatic surge in their number and scale during the 1980s transformed the politics, law, and practice of corporate governance in the United States (Bratton, 1989). Suddenly, the composition and fiduciary duties of boards of directors became critically important as target corporations defended themselves against takeovers. Raiders and other takeover specialists carried the rhetorical and ideological banner of shareholder value and shareholder primacy in their legal and political struggle against managerial defences.<sup>11</sup> The market for corporate control was heralded as the solution to corporate governance problems and as embodying the passing of American capitalism from the era of managerialism to one of shareholder capitalism.

Facing the prospect of hostile takeovers, corporate managers met the limits of their tolerance for the market. Takeovers obviously threatened managerial security and prerogatives. Coming at the trough of American deindustrialization and in the wake of the severe recessions of the early 1980s, hostile takeovers also raised intense concerns over national economic decline and attendant social disruption that galvanized broad-based political opposition. Widespread suspicion of concentrated financial power, a crisis in the industrial economy during the 1980s, and the mobilization of politically powerful managers and local populist interest groups

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<sup>10</sup> See also *Santa Fe Industries Inc. v. Green*, 430 U.S. 462, 477-78 (1977) (primary concern of the Securities and Exchange Act is disclosure, while the substantive fairness of transactions is "at most a tangential concern of the statute").

<sup>11</sup> For the relationship between the contractual theory of the firm, shareholder interests, and the rise of hostile takeovers, see *id.*: 1518-25.



generated a potent policy backlash (Roe, 1993). Court decisions significantly weakened fiduciary duties by sanctioning a plethora of takeover defences. Many states, with the important exception of Delaware, adopted harsh anti-takeover statutes. By the early-1990s, hostile takeovers were few and far between, replaced by friendly merger and acquisition deals that typically included substantial benefits for incumbent managers and directors. The backlash against takeovers set the stage for the politicization of the law and practice of American corporate governance. As the market for corporate control reached its political limits, attention turned to other mechanisms of corporate governance to balance and adjust the interests of corporate stakeholders. Managers, institutional investors, shareholder groups, financial institutions, financiers, and unions sought to enshrine their policy preferences in the statutory law, regulation, legal doctrine, and “best practices” of corporate governance. Yet the politics of corporate governance and securities law during the 1990s revealed interest group conflict and policy confusion that precluded substantial reform.

## B. THE SEC IN THE 1990S: BIPOLAR ACTIVISM WITHIN POLITICAL CONSTRAINTS

The conservative ascendancy and the takeover wave of the 1980s heightened political conflict over corporate governance reform. As a result, during the 1990s, the SEC was whipsawed between managerial and pro-shareholder groups, along with their respective political allies. In the political battles that ensued, the SEC got little effective political support from shareholders. For one thing, diffuse and fragmented shareholders face insurmountable collective action problems that make unified and coherent action in opposition to managers a near impossibility.<sup>12</sup> These same

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<sup>12</sup> This fact reflects the core insight of Berle and Means’ classic 1932 work on the separation of corporate ownership and control, which has informed much of the political and economic analysis of corporate governance ever since. (Berle and Means, 1932)

collective action problems are magnified in the much larger political arena and afflict the political strength and effectiveness of shareholders as a class and as an (potential) interest group. Second, the pro-shareholder forces were also split among themselves with respect to their preferred mode of corporate governance reform. One group favored expanded formal disclosure regulation, enforced by the SEC (and to a lesser extent private litigation). The other sought to encourage the monitoring of management and corporate governance activism by institutional investors. The peculiar vacillations of SEC policy during the 1990s reflected this political and ideological conflict. From 1992 to 2000, the SEC under Arthur Levitt, a Clinton appointee, and his Republican predecessor, Richard Breeden, initiated a series of reforms to protect shareholders by improving managerial accountability and financial transparency—with mixed political and practical success.

In 1992, after several years of pressure from institutional investors, the SEC under Breeden reformed its proxy statement rules to encourage corporate governance activism among large institutional investors by eliminating the requirement to disclose communications among large shareholders, thereby making it easier (and cheaper) for them to communicate with each other and with management.<sup>13</sup> The amendments unleashed the fiercest fight over SEC rule changes in the agency's history up to that time.<sup>14</sup> In contrast to the transparency and disclosure rules common in

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<sup>13</sup> See 57 Fed. Reg. 48,276, 48,283 (1992), Regulation of Communications Among Shareholders, Securities and Exchange Commission, 17 CFR Pts. 240 & 249, Release Nos. 34-31326; IC-19031; File No. S7-15-92 (October 22, 1992). See Minow, 1991: 149 (arguing that previous federal corporate governance reforms had been generally initiated internally by government agencies, but that institutional shareholders drove the 1992 proxy reforms); see also Frenchman, 1993: nn. 2, 6 & 155-156 and accompanying text.

<sup>14</sup> Over 1,700 comment letters flooded into the SEC and business attacks on the proposal were even more heated than the statements in support. The rule inflamed economic conflicts and ideological debates over the merits and legitimacy of managerialism and the potential financial and governance power of institutional shareholders. See Cioffi, 2002: pp. 210-212.

American securities market regulation, the 1992 proxy rules reduced disclosure obligations and represent an experiment in structural regulation that altered intra-corporate power relations by design to achieve the policy goal of increased monitoring and governance activism by institutional investors. The 1992 proxy rule changes appear to have encouraged greater governance activism by institutional investors, but at the expense of transparency. Institutional investors, with some notable exceptions, preferred to voice their concerns and criticisms to management in private communications that would not depress the price of their stock holdings (*See Zanglein, 1998*). These discussions and their contents no longer had to be disclosed in proxy statements, at the risk of privileging large institutions over small investors in access to information. The use of structural regulation in this case exacerbated problems of transparency, opportunism, and insider trading.

The SEC under Levitt pursued a more activist policy agenda favoring small shareholders, but was most spectacularly and soundly defeated in attempts to reform the accounting treatment of stock options and to curb conflicts of interest in the accounting industry in order to improve the accuracy of audits. Fearing that accounting firms acting simultaneously as consultants and auditors would compromise the integrity of their auditing in order to generate and keep lucrative consulting contracts, the SEC wanted to prohibit accounting firms from handling both auditing and consulting work for publicly traded corporations. Accounting firms enlisted allies in Congress to fight on their behalf and bring legislative pressure on the SEC, until the regulatory proposal was withdrawn.<sup>15</sup> Likewise, the SEC under Levitt failed in its attempt

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<sup>15</sup> The regulation of accounting firms and their conflicts of interest became an especially important issue following a 1994 Supreme Court decision that largely abolished “aiding and abetting” liability, under which accounting and law firms could be held liable for fraudulent statements and omissions by publicly traded corporate clients. *Central Bank of Denver v. First Interstate Bank of Denver*, 511 US 164 (1994). Without the threat of private litigation, SEC regulation was

to require the expensing of stock options in corporate financial statements managers growing rich on huge grants of stock options and “New Economy” technology firms dependent on options as a form of compensation enlisted bipartisan congressional and executive branch support to quash the initiative.

However, the Levitt SEC was successful in pushing through a new regulation that ended the practice of selective disclosure of important business and financial information to favored analysts and institutional investors. In response to the proposed reform, the SEC received over 6,000 comment letters eclipsing the former record set by the 1992 proxy reforms (SEC, 2000: § II A (1), especially n. 9). One indication of the intensifying public salience and conflict over corporate governance issues In August 2000, the SEC shifted direction with the adoption of Regulation “Fair Disclosure” (“Regulation FD”) (SEC, 2000). Regulation FD prohibited selective disclosure of material information by corporate managers to favored analysts, financial institutions, and institutional investors if that information is not released to the general public. The SEC promoted formal equality among shareholders by addressing the problem of informational asymmetries that disadvantage small investors vis-à-vis large institutions. Further, Regulation FD expressly rejected private litigation by shareholders and relied exclusively on SEC enforcement.

The 1992 proxy reforms and Regulation FD reflect a fundamental tension and confusion in SEC policymaking. They are at cross-purposes. Regulation FD undermined the SEC’s own 1992 proxy reforms by limiting the ability of institutional investors to pursue corporate governance activism through private communications with managers and board members. The logic of monitoring by institutional investors tends to conflict with the logic of equal

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the only enforcement option remaining. Tort reform legislation in 1995 (*see* Part III. A, below) authorized aiding and abetting suits brought by the SEC, but not by private plaintiffs.

access to information for all shareholders. More fundamentally, the mechanisms of structural regulation may often conflict with established forms of disclosure regulation. The tensions in SEC policy and approaches to regulation were exacerbated by political struggle between Republicans and Democrats over the regulation of business and the growth of the regulatory state. An alliance between political conservatives and managerialist interests sought to curtail litigation and expand managerial prerogatives through litigation reform. A more nebulous opposition alliance between the political center-left, organized labor, and a number of institutional investors and shareholder groups sought increasingly stringent regulation to protect investors from fraud and opportunism by financial and managerial elites. Contradictory regulatory policies and rules embodied this conflict. The 1992 proxy rule amendments presumed that more intensive communications between institutional investors and managers would benefit all shareholders. Regulation FD presumed that such communications fostered unfairness and insider trading. By the end of 2000, these two dominant paradigms of corporate governance regulation and reform had collided on the levels of politics, law, and corporate practice.

### **III. THE POLITICS OF SECURITIES LITIGATION REFORM IN THE 1990s**

#### **A. NEO-LIBERALISM AND STRUCTURAL EXPERIMENTATION: THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995**

Litigation has played a uniquely prominent role in American securities regulation and corporate governance. Securities fraud suits have long served as a major, if controversial, mechanism for defining and enforcing shareholder rights in the United States. Criticism of securities litigation began to intensify during the merger and acquisition boom of the 1980s and the subsequent

recession and bankruptcies of the early 1990s.<sup>16</sup> Securities litigation had steadily increased from the 1970s to the 1990s.<sup>17</sup> Firms were sued with greater frequency—often in response to inevitable market fluctuations in the price of securities. In part, the rise in litigation rates was due to the development of a sophisticated plaintiff-side securities litigation bar that produced a veritable litigation industry and provided substantial financial backing to the Democratic Party. But the increase in litigation also reflected the growing stakes and contentiousness of inter-corporate battles, the expansion of securities fraud law into new areas, and the increased use of sophisticated and often manipulative financial practices. The rise in securities litigation rates expanded the size of the anti-litigation coalition and the intensity of its opposition to liberal securities laws and legal doctrines. In addition to corporate managers, the traditional foes of securities litigation, securities litigation reform legislation was supported by securities firms and accounting firms, along with the economically ascendant Silicon Valley firms that depended upon equity financing. (Avery, 1996: 339-54; Kelleher, 1998: 51-53)

By the early 1990s, these critics found both political parties increasingly congenial to their pleas for legislative relief from lawsuits. As part of a more business-friendly political strategy and policy agenda, the Democrats had sought to neutralize the issue by drafting more moderate reform legislation in 1993 and 1994 that balanced the interests of corporations, shareholders, and plaintiffs' attorneys.<sup>18</sup> Driven by interest group loyalties, political calculation, and an increasingly hard-line ideological approach to

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<sup>16</sup> For an overview of the debate *see* Alexander, 1991; Seligman, 1996; for the influence the debate over the incidence and excesses of securities litigation on the drafting and passage of the PSLRA, *see generally* Avery, 1996.

<sup>17</sup> The rate and significance of the increase in securities litigation has been, and continues to be, hotly debated. *See* Alexander, 1991; Seligman, 1996; *see also* United States Senate, 1993.

<sup>18</sup> *See* Seligman, 1996: pp. 717-719; 140 Cong. Rec. S3685, S3696-3707 (daily ed., Mar. 24, 1994) (statement of Senator Dodd, co-sponsor of S. 1976).

policy, the Republican Party pushed for more substantial legal change. In 1993 the Republicans included securities litigation reform a component with their "Contract with America" campaign platform. After the 1994 "Republican Revolution," in which the right wing of the Republican Party took control of the Congress under the leadership of Newt Gingrich, the party made good on their promise.

The new Republican majorities in both houses of Congress shifted the terms of the securities litigation reform debate to the right and set to work drafting their own legislation. After three years of fierce political conflict and an epochal shift in the control of Congress, conservative congressional Republicans spearheaded the passage of the *Private Securities Litigation Reform Act of 1995* (the PSLRA) over President Clinton's veto.<sup>19</sup> Intended to curtail the use of the courts and litigation for the prosecution of securities fraud claims, the PSLRA placed more stringent pleading requirements on securities fraud suits in an attempt to streamline the procedure for dismissing these suits before they entered the expensive discovery phase (Securities Regulation & Law Reporter (BNA), 1995). Its proponents hoped that the law would reduce the settlement value of, and thus the incentive to file, weak or meritless suits. President Clinton voiced general support for securities litigation reform in the securities area, as did many Democrats in Congress. However, he vetoed the legislation on the grounds that it imposed an excessively stringent standard for pleading securities fraud claims.<sup>20</sup> The PSLRA became law as

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<sup>19</sup> PSLRA, Public Law: 104-67 (December 22, 1995), amending Title I of the Securities Act of 1933, 15 U.S.C. 77a *et seq.*, Pub. L. No. 104-67, 109 Stat. 737 (1995). For the Congressional veto override, *see* 141 Cong. Rec. S19,180 (daily ed. Dec. 22, 1995) (Senate); 141 Cong. Rec. H15,223-24 (daily ed. Dec. 20, 1995) (House of Representatives). For the text of President Clinton's veto message, *see* 141 Cong. Rec. H15,214-15 (daily ed. Dec. 20, 1995). For background and practical analysis of the PSLRA, *see* Clark, 1997: 386-388; Seligman, 1996.

<sup>20</sup> Clinton, 1995; *see* Lewis, 1995. Clinton's veto message objected that "the pleading requirements of the Conference Report with regard to a defendant's

Congress overrode Clinton's veto by a vote of 319 to 100 in the House and 68 to 30 in the Senate. The success of the veto override—the only time Congress overrode a veto by President Clinton during his two terms in office—reflected a sea change in American politics and policy characterized by the hardening of Republican opposition to private litigation, eroding support of Democrats for private litigation as an enforcement mechanism, and the growing political influence of corporate managers. The political center gravity in Congress shifted decisively against private litigation as a favored mechanism of policy enforcement.

The PSLRA also reflected the struggle to find alternative enforcement mechanisms to replace private litigation. By the 1990s, policy makers were faced with a dilemma. Business and professional interests had mobilized to form a powerful coalition against securities lawsuits. Yet, lawsuits were a central enforcement mechanism in the American securities law and corporate governance machinery. The PSLRA embodies three of the alternatives: (1) the use of institutional investors to monitor plaintiffs' attorneys on behalf of all shareholders; (2) reliance on certified public accountants as informational intermediaries and monitors of corporate finances, management and boards of directors; and (3) litigation by the SEC rather than private plaintiffs and attorneys. The first of these alternatives, and to more limited extent the second, represented a nascent structural turn in securities and corporate governance law. Rather than prescriptive rules backed by the threat of litigation, private actors would perform governance and enforcement functions in a largely autonomous fashion through the deliberate design of institutional relationships and incentives under law. Not only would expensive and inefficient litigation be reduced, in some respects the autonomy of the private sphere would be preserved and even reinforced.

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state of mind impose an unacceptable procedural hurdle to meritorious claims being heard in Federal courts."



The growing importance of institutional investors was evident in the design of securities law enforcement mechanisms as reconfigured by the PSLRA. The 1995 legislation created the position of “lead plaintiff,” generally the shareholder with the largest stake in the relief sought, that was expected to curb alleged excesses in shareholder litigation.<sup>21</sup> The provision gives the lead plaintiff greater power to police shareholder securities litigation, promote the swift disposition of meritless suits, and prevent collusive settlements. The provision recognized the size and corporate governance potential of institutional investors by legally empowering them as an institutional counterweight to both plaintiffs’ attorneys and to managerial power. Congress wishfully saw institutional investors as a means of resolving the enforcement problem. Institutional investors were cast collectively as less disruptive, adversarial, and litigious agents of market regulation. This image of self-regulation by rival capitalists appealed to policy makers and managerial interests alike.

The interposition of institutional investors between the plaintiffs’ bar and defendant corporations produced unintended and paradoxical results. (Securities and Exchange Commission, 1997) Institutional investors initially had little interest in intervening to terminate lawsuits and incur a possible breach of fiduciary duty suit from other, smaller shareholders (Grundfest and Perino, 1997). The expense and unpredictability of litigation and the fear of potential liability to other shareholders displeased with their conduct as lead plaintiff discouraged deep-pocketed institutional investors from curbing securities litigation.<sup>22</sup> Instead, they used this new power to intervene with growing frequency in securities

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<sup>21</sup> PSLRA, § 27(a)(3)(A) & (B), 15 U.S.C.A. §§ 77z-1(a)(3)(A) & (B); 78u-4(a)(3) (A) & (B) (procedure and substantive criteria for appointment of “lead plaintiff”). This provision was inspired by an inventive law review article by Weiss and Beckerman (1995).

<sup>22</sup> However, the more stringent standards the PSLRA imposed on the civil procedure rules for pleading scienter did empower *courts* to curb securities litigation. *See, e.g.,* Sale, 1998; Johnson, 1997.

litigation to prevent plaintiffs' counsel from cutting opportunistic collusive settlement deals with managers in meritorious cases, thereby *prolonging* litigation and *increasing* the amount of final settlements and damage awards (Johnson, 1997). Thus, the Act simultaneously reformed securities litigation and increased the power of the funds—but not in the way its sponsors anticipated.

The PSLRA's use of auditors to detect fraud and the SEC civil actions enforce the securities laws proved far less effective. As is abundantly clear in hindsight, Title 3 of the PSLRA, which contains the auditing and auditor disclosure provisions, failed to address the basic conflicts of interest in the management-auditor relationship and did not provide a functional structural alternative to litigation as an enforcement mechanism. Instead, during the late 1990s, auditing firms became—knowingly or unknowingly—instrumental in the manipulation or outright misrepresentation of corporate finances. The relatively hands-off regulatory approach to the accounting industry failed to empower or compel it to play the structural monitoring role purportedly sketched out for it by Congress in the PSLRA. In part, the failure of Title 3 to improve the quality of audits was due to the politics of litigation reform. Auditor responsibilities under the PSLRA were enforceable by the SEC alone, not by private litigation, and only when auditors filed a report of suspected illegal activity. The Act was insufficient to alleviate the conflicts of interest entrenched within the accounting industry and auditor-client relationships.

More generally, SEC civil and criminal actions authorized under the PSLRA<sup>23</sup> failed to fill the enforcement gap left by securities litigation reform. At precisely the time when the law placed greater responsibility on the Commission to pursue enforcement, the stock market boom of the late 1990s sent agency's workload spiraling upwards and the SEC's budget lagged far behind the

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<sup>23</sup> See 15 U.S.C. § 77t(f) (authorizing SEC actions for "aiding and abetting liability), 15 USC 78j-1(d) (SEC has exclusive authority to enforce auditor's duty to disclose fraud and penalize violations).

demands placed upon it. The agency's turnover and depletion of skilled personnel soared during the 1990s and early 2000s as the SEC's budget condition and staffing deteriorated relative to the increasing demands on its resources. Only after the surge of destructive corporate finance scandals following the collapse of Enron in 2001 did Congress take action to substantially increase the SEC's budget and authorize the hiring of enforcement personnel. The PSLRA's experiments with structural regulation failed. But the law and subsequent legislation revealed a clear and potent political realignment antagonistic to securities litigation. The political constraints that precluded the adoption of litigation-driven enforcement mechanisms in securities regulation and corporate governance law would even withstand the post-Enron corporate governance crisis.

#### B. NEO-LIBERALISM THROUGH CENTRALIZATION: THE SECURITIES LITIGATION UNIFORM STANDARDS ACT OF 1998

The failure of the PSLRA to effectively stem the flow of securities fraud suits drove the Act's proponents to redouble their efforts. The federal character of the United States and its fragmented legal and regulatory systems further impaired the effectiveness of the federal securities litigation reforms. Although the number of securities fraud lawsuits dismissed by federal courts rose sharply from 13 to 30 per cent between 1995 and 2000, critics of litigation asserted that the number filed in state courts had risen and would continue to rise sharply (*See* Loomis, 2000; Caiola, 2000: nn. 183-190 and accompanying text ). These suits were brought under federal securities laws (over which the state courts had concurrent jurisdiction) and under the states' "blue sky" laws. These state laws formed a parallel securities law regime available to plaintiffs' attorneys as access to the federal courts was curtailed. Congressional securities litigation reformers sought to close this avenue, arguing that it circumvented the PSLRA and invited a splintering of the legal standards governing publicly traded corporations. However, to do so by preempting state laws, the Republican right in Congress would have to directly repudiate

their professed commitment to federalism and the devolution of political and regulatory power.

Spurred on by arguments—and at best ambiguous evidence<sup>24</sup>—that the PSLRA had pushed securities litigation into state courts, Congress passed the *Securities Litigation Uniform Standards Act of 1998* (SLUSA) to close the alleged loophole.<sup>25</sup> The SLUSA was a second sweeping securities litigation securities litigation reform bill that preempted the securities fraud provisions of state blue-sky laws and granted federal courts exclusive jurisdiction over securities lawsuits brought under federal law.<sup>26</sup> This time the Republicans had additional Democratic support, especially from the California delegation that had become increasingly concerned over securities suits against Silicon Valley corporations dependent upon securities markets for raising capital.<sup>27</sup> The bill passed in the Senate by 79-21, carrying a majority of Democrats (26 to 19) and only two Republicans voting against the measure, and in the House by 319 to 82. Not a single Republican voted against the bill

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<sup>24</sup> See Caiola, 2000: nn. 186-190 and accompanying text.

<sup>25</sup> SLUSA, Pub. L. No. 105-353, 112 Stat. 3227 (codified as interspersed subsections of 15 U.S.C. §§ 77-78). For analyses of the legislative history and political ramifications of the SLUSA, see Thompson, 1999; Pritchard, 2000; Caiola, 2000.

<sup>26</sup> Two years earlier, Congress had enacted another—more modest—preemption statute that conferred exclusive federal jurisdiction over the regulation of securities registrations (i.e., the initial marketing and sale of publicly traded stock). See *National Securities Markets Improvement Act of 1996*, Pub. L. No. 104-290, 110 Stat. 3416; see especially 15 U.S.C.A. § 77r (West Supp. 1999). The NSMIA conferred exclusive federal court jurisdiction over the primary subject matter of the Securities Act of 1933. The SEC and Clinton administration successfully fought off a Republican attempt to enact a far more radical preemption of state securities regulation. See Seligman, 2003: pp. 674-681. The SLUSA extended preemption to the primary subject matter of the much broader and more important Securities and Exchange Act of 1934.

<sup>27</sup> See *id.* n. 190 (citing S. Rep. No. 105-182, at 4-5 (1998) (written testimony of Commissioner of the California Department of Corporations that without federal preemption and uniform rules the state with the most lenient securities fraud law will govern in a national marketplace)).

in the House, while a majority of Democrats voted for it, 106 to 80. They also won the support of moderate Democrats in Congress who were eager to cultivate high-tech industry support. Chastened by the PSLRA veto override and acutely sensitive to the political trends supporting litigation reform, the Clinton Administration also signed on in support of the legislation (Clinton, 1998).

The SLUSA centralized regulatory authority over securities markets in striking fashion. The political potency of the shift away from litigious enforcement mechanisms and the growing political power of anti-litigation constituencies overrode the sentiments and rhetoric of conservative neo-federalism. Despite the title emphasizing “uniform standards,” the main goal of the law was to reduce litigation, not to create clearer or more coherent legal doctrine. Though the centralizing effect of the PSLRA and SLUSA collided with the entrenched structures of federalism in corporate governance law, they preserved the overlap of state corporate law with federal securities regulation. The SLUSA contained provisions, called the “Delaware carve outs,” that explicitly protected state fiduciary law and related derivative suits from preemption. Federal securities litigation reform thus generated opposing policy incentives: further fragmentation of corporate governance law by inducing increased reliance on state corporate law versus an even more radical intrusion of federal law into the traditional core areas of state corporation law. It was in this context of tension within and among policy approaches, and conflict between political parties and coalitions that the great 1990s stock market bubble burst to reveal the shady practices, mass delusion, and outright fraud that the economic boom had concealed. The resulting legitimacy crisis would facilitate corporate governance reform and disrupt established patterns of regulation and federalism.

#### **IV. THE SARBANES-OXLEY REFORMS: CORPORATE GOVERNANCE REFORM AND CONSTRAINED AUTONOMY IN POLICYMAKING**

##### **A. THE LEGITIMACY CRISIS OF FINANCE CAPITALISM AND THE POLITICS OF REFORM**

The politics of corporate governance reform in the United States was driven by overwhelming external forces and events that, paradoxically, endowed policymakers with a rare and short-lived period of relative autonomy from established interest group politics. The most severe legitimacy crisis of the American financial and corporate governance systems since the Great Depression inflamed political support for more wide-ranging reform of the American corporate governance regime and disrupted the grip of a conservative coalition that favored minimal regulation and had blocked pro-shareholder reforms during the 1990s. Yet public support for reform remained unfocused and detached from any specific concrete proposal, program, or policy agenda. These conditions loosened the constraints of interest group politics while increasing the autonomy of policymakers in fashioning a response to the crisis. That response became the *Sarbanes-Oxley Act of 2002*.

The corporate governance crisis revealed the necessity of strong legal rules and regulatory institutions as the foundation of functional, efficient private economic institutions—including both markets and the non-market of the corporate firm (Vogel, 1996; Cioffi, 2004b). Significantly, however, the law and the regulation it enabled did *not* loosen legislative restrictions on securities litigation, let alone create new causes of action. Instead, the *Sarbanes-Oxley Act* relied on a combination of governmental enforcement and structural regulation to carry out its reforms. Political dynamics and constraints drove the legislation in these directions.

Senate Democrats pushed through the most comprehensive corporate governance reform in the United States since the 1930s. This outcome can only be understood in the context of an unusual—and temporary—interregnum of interest group politics. The extraordinary scope, severity, and duration of these financial scandals undermined the legitimacy of managerial and professional elites and their political allies who opposed reform and allowed the Democratic leadership in the Senate, where the party held a short-lived majority prior to the 2002 midterm elections, to seize the policy agenda of substantial corporate governance reform. Under these conditions, they outflanked and overrode the resistance to pro-shareholder reforms mounted by congressional Republicans, the Bush Administration, and powerful vested managerial and accounting industry interests.

## B. THE TWIN FEARS: FINANCIAL COLLAPSE AND POPULISM

The euphoric dot.com bubble of the 1990s died a painful death, as bubbles always do.<sup>28</sup> The Dow Jones Industrial Average fell by 25 percent between its March 19, 2000 peak and July 19, 2002. The Standard and Poor 500 index lost nearly 28 percent during the same period.<sup>29</sup> The Wilshire 5000 Index, among the most comprehensive of American stock indexes, fell by over 40 per cent from its March 24, 2000 peak of \$17.25 trillion to \$10.03 trillion on July 18, 2001 (Feaster, 2002; Seligman, 2003: 624). The bursting of the stock market bubble and the sustained impact of corporate

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<sup>28</sup> For a classic account of financial bubbles and crashes, *see* Kindleberger, 1989/1978. For an extremely insightful and prescient study of the dot.com bubble of the 1990s published just before the American stock market crash, *see* Shiller, 2000.

<sup>29</sup> *See* Graham, Litan, and Sukhtankar 2002: 3. A further breakdown of these losses indicates the importance of the disclosure of the WorldCom fraud. Fully 14% of the aggregate 25% DJIA loss occurred after the WorldCom disclosure on June 24<sup>th</sup>. The S&P lost 15% of its 28% total loss from the date of the disclosure. *Id.*

scandals and bankruptcies from the collapse of Enron in December 2000 wiped out approximately seven trillion dollars of market capitalization. According to one estimate, 17 per cent of these losses were attributable to the wave of corporate finance scandals (Graham, Litan, and Sukhtankar 2002: 2).

The crash not only destroyed investors' portfolios, it also revealed the manipulative and often outright illegal financial conduct of corporate managers, accountants, financial institutions, and attorneys. The precipitous decline of the stock markets drained a swamp of misconduct that many suspected during the boom, but few were willing to directly or clearly acknowledge.<sup>30</sup> The crash revealed the deterioration of the quality of accounting and financial disclosure—followed by a collapse of public confidence in the reliability of each. Joel Seligman notes that “[b]etween 1997 and 2001 the number of earnings restatements grew each year from 116 in 1997, to 158 in 1998, 234 in 1999, 258 in 2000, and 305 in 2001” (Seligman, 2003: 624). After the collapse of the markets, the prevalence and severity of the fraud, financial engineering, earnings management, creative accounting, and other dubious financial practices of the boom years came into focus.

The mass shareholding that had developed in the United States during the 1980s and 1990s, once a key societal support for pro-market policies, now fueled pervasive cynicism, resentment, and finally fury against business, financial, and political elites.<sup>31</sup>

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<sup>30</sup> One hedge fund manager, who had correctly warned about Enron, commented about the accounting scandals, “For the most part, this stuff was hiding in plain sight[.]” (Berenson, 2002). Alan Greenspan had warned of “irrational exuberance” in the stock market years before the crash and many academic and financial commentators realized that the United States was in the midst of a stock market bubble during the late 1990s. See, *e.g.*, Shiller, 2000.

<sup>31</sup> See, *e.g.*, Gosselin and Flanigan, 2002; Norris, 2002; *Financial Times*, June 28 2002; Petrino and Yamanouchi, 2002; Morgenson, 2002; Nagourney, 2002; Dunham, 2002.



Business and neo-liberal deregulation lost their luster in both ideological and political terms. The legitimacy of finance capitalism itself appeared to teeter as the prestige and reputations of principal political and economic actors plummeted. Investor confidence in the securities markets collapsed along with stock prices. Massive corporate finance scandals at Enron, Tyco, WorldCom, Global Crossing, Adelphia, and other major corporations, along with the enormous market losses, stoked popular resentment of corporate and financial elites. Revelations of managerial fraud, looting, and empire building punctured the inflated cult of the CEO. The abuses and improprieties of corporate managers also revealed the inadequacies of corporate boards of directors, auditors and other informational intermediaries, government regulation, and regulators. In the harsh light of hindsight, boards of directors of defrauded, looted, and bankrupt firms appeared at best negligent, and at worst corrupt.

Key informational intermediaries, most importantly accountants and stock analysts, failed to protect the public interest and appeared mired in and hobbled by conflicts of interest. If Enron symbolized the culture of corporate fraud and board failure during the 1990s, its auditor Arthur Anderson represented the spread of corruption to the self-regulating professionals entrusted to protect the public interest in transparency. Likewise, stock analysts were unveiled as shills for the investment banks that employed them, and their stock ratings exposed as largely worthless and often deceptive. From Enron's collapse in autumn 2001 through mid-2002, an increasing percentage of the electorate began to view the entire financial system as built on insider conflicts, fraud, and manipulation—just as it unraveled in public.

Government did not escape the corrosive skepticism of the souring public mood. Securities regulators and prosecutors had failed to deter, detect, or punish managerial misfeasance and malfeasance. Congress was also vulnerable to charges that it had passed litigation reform legislation that intensified the pressures on the SEC while failing to provide the funding necessary for it to

function. The SEC itself was chaired by Harvey Pitt, a prominent securities lawyer known for his representation of accounting firms in private practice and an avowed skeptic of regulation. During the 1990s, congressional opposition in both parties had also rolled back a proposal by FASB to require expensing of stock options and an effort by the SEC to compel the separation of auditing and consulting services by accounting firms. Boards turned out not to be watching the CEOs, and no one was watching the watchers. Corporate managers, directors, professionals, and government all fell in the public's esteem.

By the spring of 2002, some political and economic leaders began to fear that the American financial system as a whole might collapse. The wave of corporate finance scandals and bankruptcies frayed public confidence in the soundness, stability, and fundamental integrity of the financial and corporate governance systems.<sup>32</sup> Increasingly, the public perceived that the scandals reflected fundamental corruption and dysfunction at the *core* of the American corporate governance and political systems (Graham, Litan, and Sukhtankar, 2002: 2). By late June, worries of an international financial contagion increased as American, British, French, and German stock markets each suffered double-digit losses in the first half of 2002.

"Investor confidence" became a *de facto* metric of political economic legitimacy in the context of the post-Enron corporate governance crisis. Perhaps for the first time in American history, the interests and perceptions of the investor class were viewed as

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<sup>32</sup> Enron collapsed just after the terrorist attacks of September 11<sup>th</sup>, 2001, and that the succession of post-crash scandals unfolded in the aftermath of that catastrophe. The combination of the terrorist attacks and pervasive financial scandals led policymakers in and out of Congress to fear the possibility of a general collapse of the American and international financial systems. This perception was repeatedly stated in interviews with congressional aides from both parties.

largely coterminous with those of the electorate at large.<sup>33</sup> The scandals and their increasing toll on the financial markets raised the specter of a backlash against malfeasance and misfeasance among corporate managers, directors, and the financial elite. Populist backlash against financial elites is a recurrent theme in American political and legal history. However, past episodes of backlash in response to scandal and financial crisis had been driven, or at least colored, by anti-financier populism.<sup>34</sup>

Yet, the post-Enron politics of reform was not so much anti-management or anti-financier as it was *pro-shareholder*. This reflects a substantial shift in the politics of corporate and financial regulation in the United States. Integrity and fairness of the markets, the adequacy of financial disclosure, and conflicts of interest in corporate governance were increasingly judged by the criteria of shareholder interests, rather than those of consumers, local communities, workers, unions, or small business. The post-Enron corporate governance crisis made clear that the legal rules, market and corporate structures, and regulatory enforcement that buttress shareholder interests and investor confidence had become crucial to the legitimacy of the political economic order. A striking fact about the American corporate governance crisis of the early 2000s is that *corporate governance reform was designed to restore and reinforce the structural features of the American*

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<sup>33</sup> This is not to argue that shareholder interests actually *are* indistinguishable from those of the rest of the electorate. See, *e.g.*, *The Economist*, October 19, 2000 (discussing the rise of an American “shareholder class” and Zogby data indicating the distinctive interests and policy preferences of its members).

<sup>34</sup> The work of Mark Roe (*e.g.*, 1991, 1993, 1994), for example, details the myriad restrictions placed on American financial institutions to fragment stock ownership, markets, and lines of business. These measures were intended to benefit shareholders, but they were driven by hostility to financial interests and a desire to deliberately weaken them. In contrast, recent corporate governance reforms do not seek to subordinate or disadvantage financial institutions. See also Moran, 1991 (scandal triggers financial system reform).

*political economy* as it had emerged from the 1980s, with its market-centered financial system, preoccupation with shareholder value, and financially driven corporate restructuring and strategies. From this perspective, corporate governance reform was not radical, but an essentially conservative response to crisis in a conservative era.

### C. THE RELATIVE AUTONOMY OF REFORM POLITICS

*Sarbanes-Oxley* was the product of a political struggle between Democrats using financial scandals against the Republicans, and Republicans seeking to delay or dilute the legislation in keeping with their loyalty to corporate supporters and their anti-regulation ideological policy agenda. The Democrats relied on public outrage over the scale and scope of the financial scandals of the late-1990s and its disruptive effect on interest group power.<sup>35</sup> Given the Republican Party's control of the Presidency and House of Representatives, and its greater unity and discipline within the veto-prone structure of the federal government, substantial reform was only possible under crisis conditions that weakened interest group influence and made resistance to reform intensely unpopular. Corporate governance reform in the United States was as much a product of historical contingency as of underlying structural changes in the economy.

Opponents of reform among interest groups and in the Republican Party hoped to ride out the scandals without any major legislative or regulatory initiative. Sensing political vulnerability from the spreading scandals, the Bush administration announced a ten-point plan to combat corporate corruption in early March of 2002 (Schlesinger and Schroeder, 2002). House Republicans led by Michael Oxley, Chairman of the House Finance Committee,

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<sup>35</sup> See Cioffi, 2004b (forthcoming); Romano, 2004. For contemporaneous news articles discussing the Democrats' exploitation of popular outrage over the scandals, see, e.g., Labaton and Clymer, 2002; Stevenson and Mitchell, 2002; Clymer, 2002; Stevenson and Oppel, 2002.

submitted a bill patterned after the Bush plan and began holding hearings on it in mid-March.<sup>36</sup> The bill, known as the *Corporate Accounting Reform and Transparency Act* (CARTA), garnered little praise from commentators and the public and derision from congressional Democrats as an attempt to assuage the public with symbolic legislation. CARTA was especially vulnerable because it was supported by, and imposed relatively weak restrictions on, the accounting industry. The bill created a new accounting regulation body under the control of the SEC—then chaired by Harvey Pitt who was viewed by Democrats as too sympathetic to the accounting industry and major accounting firms. As the accounting scandals continued to spread, any connection with, or indication of sympathy with, the accounting industry became politically poisonous. Early on, the Republicans knew they were seen as close to business and financial interests and therefore politically vulnerable on issues of corporate corruption. They pressed forward with Oxley's CARTA bill as a "marker" intended to frame the legislative debate over reform and establish the party's bargaining position against the Democrats.<sup>37</sup>

Shortly after the Republicans began work on CARTA, Senate Democrats, led by Banking Committee Chairman Paul Sarbanes, began holding hearings on the scandals and potential legislative responses to the crisis. Because they were completely shut out of the Republican-dominated House legislative process, the Democrats' policy positions could only be channeled through the

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<sup>36</sup> Though named for both Democratic Senator Paul Sarbanes and Republican Representative Michael Oxley, Sarbanes was the law's chief architect and congressional proponent. Oxley only signed onto the Sarbanes' bill once the White House chose to support passage of the Senate bill in order to control the political damage that the GOP was beginning to incur as the November 2002 mid-term elections approached and the corporate scandals continued to spread. Interviews, Washington, DC, March 2003, March 2004. Both Democratic and Republican interviewees recounted this version of events. *See also* VandeHei, 2002 (Oxley criticizing the Sarbanes bill before conference committee).

<sup>37</sup> Interviews, U.S. House of Representatives, U.S. Senate, and former congressional staffers, Washington, DC, March 2004.

Senate where they held a short-lived one-vote majority following Sen. James Jeffords' defection from the Republican Party.<sup>38</sup> Of the numerous committees that held hearings on Enron and the unfolding corporate governance crisis, however, the staid Committee on Banking, Housing, and Urban Affairs took the lead on accounting and corporate governance reform. The committee had jurisdiction over the securities law and accounting issues that were seen as central to the crisis.<sup>39</sup> The Banking Committee was the ideal place for a reform bill to originate if it was to have a chance of passage. It had a reputation for relative collegiality and technical sophistication.<sup>40</sup> The technical focus of its members (with some exceptions) favored a more sober and deliberate legislative process less easily derailed by partisan rhetoric, posturing, and ideology.

The populist backlash against the managerial and professional classes triggered by the massive post-bubble corporate financial scandals was conjured vividly in congressional hearings on the scandals and debates over responsive reforms. In the more ideologically-driven and rhetorically astringent House, Representatives sought to outdo one another in their denunciations of greed and corporate fraud and malfeasance. Democrats sought to seize the political mantle of reform and capitalize on the scandals by denouncing Republican neo-

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<sup>38</sup> This majority was precarious, and the public's attention to and memory of financial scandals was short. Following losses in the November 2002 mid-term elections, both the Democrats' control of the Senate and the public's fixation on corporate finance scandals were gone.

<sup>39</sup> The Senate Judiciary, Commerce, Labor, Tax, and Investigations committees held hearings on issues raised by Enron and the crisis of corporate governance, but their jurisdictional competence was either too narrow or comparatively peripheral to frame a comprehensive policy response.

<sup>40</sup> Sarbanes, although on the left of the Democratic Party, commanded respect across the aisle as very smart, tough "workhorse" legislator, and was so described by interviewees inside and outside of government. Even many House Republicans held him in high regard. Interviews, U.S. House of Representatives, U.S. Senate, and former congressional staffers, Washington, DC, March 2004.

liberalism and systemic flaws in securities regulation and corporate governance. The Republicans set out to neutralize these attacks by adopting the rhetoric of shareholder value and confidence while framing the scandals as a matter of a few “bad apples” rather the product of structural flaws in regulation and corporate governance.

The rhetoric of shareholder value filled the chambers of Congress. Rep. Michael Oxley, the Republican Chairman of the House Committee on Financial Services, introduced a hearing on Republican sponsored reform legislation by arguing that,

“There should be no question that the Federal securities laws need to be updated to ensure that investors have access to transparent, and meaningful information concerning public companies. Enhancing the public’s faith in financial statements is absolutely critical. They serve as the bedrock of our capital markets” (U.S. House of Representatives, 2002a: 1).

The ranking minority member on the Committee, Democratic Rep. John LaFalce of New York, made a similar point that legislative reform was necessary to “restore confidence in the integrity of our markets,” but also slipping in an attack on the PSLRA and SLUSA.<sup>41</sup>

Similar language permeated the Senate debates over corporate governance reform. Senator Sarbanes opened the Senate hearings on reform legislation by positing, “It is commonplace, but nonetheless worth repeating, that our markets depend on investors’ confidence” (United States Senate, 2002, vol. 1, February 12, 2002: 2). He uttered a stark warning in the second hearing: “[T]here is, I think it is fair to say, a crisis of confidence”

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<sup>41</sup> U.S. House of Representatives, 2002a: 3-4; *see also* U.S. House of Representatives, 2002b: 53-54 (Democratic critique of restrictions on securities litigation and liability).

(*Id.*: 97). A number of Democrats sharpened this general argument into a slashing attack on the Republicans' largely neo-liberal domestic policy agenda, including litigation reform, which they presented as pro-management, anti-investor, and increasingly dangerous to economic stability.<sup>42</sup> Republicans sought to neutralize the Democrats' attacks and frame an alternative policy position by using the same language of trust and investor confidence. Michael Enzi, a Republican and the Senate's only certified public accountant, echoed the sentiment, arguing that "the strength of our markets is only as strong as the underlying confidence in the listed companies" and acknowledging the role of government: "Congress and the SEC must find a middle ground... We must continue to convince investors, that at the core of the American capital markets, there must be a high level of integrity and ethics by all players" (United States Senate, 2002, vol. 3: 1203).

Legislative results accompanied this rhetoric of shareholder interests and investor confidence produced only because the corporate governance crisis had generated conditions that suspended interest group politics as usual. A striking and important feature of the reform politics of 2001-2002 was the disintegration of interest group influence and the predominance of entrepreneurial political actors in Congress.<sup>43</sup> Tainted by scandal, corporate managers, accounting firms, and investment banks were weakened within the legislative process. Corporate managers remained peripheral to the legislative process as a result of their loss of prestige and influence in the wake of successive corporate scandals and the popular perception that they, as a class, had looted American corporations and stolen from their shareholders.

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<sup>42</sup> See United States Senate, 2002, vol. 3: 1206-1213 (remarks of Sen. Reid), 1262-1263 (remarks of Sen. Wellstone), 1291-1292 (remarks of Sen. Durbin).

<sup>43</sup> This analysis was originally developed in Cioffi, 2004b (forthcoming), see also Cioffi, 2004a.



Business interests were also deeply divided over reform. The financial services sector was divided in their interests and preferences concerning the proper extent of corporate governance reform and government regulation of business and markets. Financial institutions, such as investment banks, were split. They are dependent on public faith in the integrity of the securities markets, but are also privileged insiders that benefited from the status quo and stood to lose from reform. In addition to intra-sectoral divisions, financial institutions and service providers were weakened in the political process by their alleged roles in numerous scandals—such as dishonesty and conflicts of interests in stock analysis, initial public offering and stock market manipulation, and the aiding and abetting dishonest of corporate executives.

The institutional investor community remained split over legislative and regulatory reforms. Large public employee and union pension funds (such as CalPERS and TIAA-CREF) and institutional investor groups like the Council of Institutional Investors, long involved in a largely non-regulatory and voluntarist form of corporate governance activism, shifted their policy preferences dramatically in support of increased regulatory stringency and intervention in corporate governance. In contrast, corporate pension funds and most mutual funds—either controlled by or beholden to corporate managers—did not press for reform. The AFL-CIO and labor unions were strongly supportive of corporate governance reform. The reforms promised greater union influence in corporate governance through their close connection to union pension funds. Further, as representative organizations, unions and the pension funds they helped administer sought to protect their members' reliance on private pension investments. Finally, the unions' historical antagonism towards management (particularly where financial manipulation enriched bosses at the perceived expense of workers) fueled an enthusiasm for reforms that would curtail managerial power. But organized labor had little impact on the substance of the reforms, though its representatives were later instrumental in rounding up Democratic votes in Congress for the final passage of the *Sarbanes-Oxley* bill. The

influence of public pension funds and organized labor on the content of the reforms, like that of other interest groups, was minimal.

The split in the business community (never as homogenous an interest group category as often implied) only widened as the corporate scandals deepened. A significant number of leading financial figures, including billionaire investor Warren Buffett, former Federal Reserve Chairman Paul Volcker, and Goldman Sachs CEO Henry Paulson, publicly supported legislative and regulatory reform (Smith and Craig, 2002). Leading investment firms understood the depth and seriousness of the crisis, and they had an enormous stake in ensuring that it was contained—by regulatory reform if necessary. Likewise, the New York Stock Exchange also came out in support of reform—also in order to calm investors and restore confidence. The leading business lobbying groups, the Business Roundtable and the Chamber of Commerce divided over the proposed reforms. The Chamber of Commerce, historically more ideological in its intense opposition to government regulation, fought a rear guard battle against the reforms. The Business Roundtable, the preeminent lobbying group of corporate America, remained moderately opposed to reform. In the end, however, even the Roundtable, whose membership of predominantly large public corporations had long been opposed to government (including judicial) intervention into corporate governance, supported the *Sarbanes-Oxley* reforms. By late June 2002, the Business Roundtable's President, John J. Castellani, announced,

"We've passed the critical mass, both from the standpoint of the political structure as well as the erosion of confidence of the capital markets in corporate America... It bodes for quicker and more intensive action" (Stevenson and Mitchell, 2002).

The accounting industry, having much to answer for and fearing even more to lose from reform, fought strenuously against the legislation—even at the risk of further antagonizing public

opinion—but were in no position to stem the tide of popular opinion and political momentum. The large accounting firms, down to the Big Four after the indictment, collapse, and conviction (in that order) of Arthur Anderson, and the accounting industry's trade association (the American Institute of Certified Public Accountants) were tainted by association with scandal, fraud, and conflicts of interest. Each of the Big Four was implicated in scandals. Collectively, the industry had lost its legitimacy as a profession. As the legislative process moved forward, some Republican staffers on Capitol Hill even told accounting industry lobbyists to stay away—their very presence was politically damaging.<sup>44</sup> By July 2002 one accounting industry representative speaking to a senior congressional aide expressed the views of many in an industry and profession besieged by scandal, bad press, and a plummeting reputation: “Just make it stop.”<sup>45</sup>

The discrediting of and division among economic elites and interest groups increased the autonomy of policymakers. This left the reformers in the Democratic Party remarkably unconstrained by interest group politics and free to capitalize on the public resentment of corporate managers and financial institutions in pushing the reform legislation. The drafting and passage of the *Sarbanes-Oxley Act* were driven by Senate Banking Committee Chairman Paul Sarbanes of Maryland. In contrast to the Republicans in both the House and Senate, Sarbanes and a majority of his fellow Democrats were favorably predisposed towards reform. The Democrats' slim Senate majority gave Sarbanes the institutional power to frame and advance a specific and technical legislative agenda. The Democrats draped their concerns and proposals in the rhetoric of pro-shareholder fairness and regulatory reform that was overwhelmingly supported by public opinion. The Senate Banking Committee moved

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<sup>44</sup> Interview, former senior Republican staff member, House Finance Committee, March 2004.

<sup>45</sup> *Id.*

deliberately through the winter, and more quickly during the late spring, and early summer of 2002, as the scandals and the sense of financial crisis among the public and the political economic elite escalated.

By June 2002, the reform politics had taken on a life of its own beyond the control of interest groups and even Congressional party leaders. After cooling somewhat during the spring of 2002, the sense of panic and outrage spiraled upwards again as the corporate financial and accounting scandals culminated in late June with the multibillion-dollar collapse of WorldCom, following disclosure of a multi-billion dollar accounting fraud. The WorldCom collapse finally eroded Republican resistance to Democratic legislative reforms.<sup>46</sup> Public demand for securities law and corporate governance reform had become irresistible. The Bush Administration and much of the Congressional Republican leadership sought to neutralize the scandals as a potent November 2002 election issue by supporting corporate governance reform and accepting only minor compromises from the Democrats as the price (Associated Press, 2002; Oppel, 2002). One Republican staffer on Capitol Hill summed up the end game of the behind-the-scenes struggle over corporate governance reform: "Congress didn't pass *Sarbanes-Oxley*, WorldCom did."<sup>47</sup>

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<sup>46</sup> The WorldCom fraud and bankruptcy decisively reinforced public perceptions of systemic corruption and stoked both fear and outrage. See, e.g., Waters, 2002; Chaffin and Bowe, 2002. For press accounts of the collapse of WorldCom see Noguchi and Merle, 2002; Feder, 2003 (\$3.8 billion fraud originally disclosed later found to total between \$9 and \$11 billion). The WorldCom scandal focused public attention once more on the passivity and conflicts of corporate directors who enabled or at least failed to prevent managerial fraud and looting. See Norris, 2003.

<sup>47</sup> Interview, Washington, DC, March 2004. Interviewees inside and outside government unanimously agreed that the WorldCom collapse broke Republican resistance to the *Sarbanes* bill and made substantial corporate governance reform politically inevitable.

The question remains, why did the Democrats give up so potent a campaign issue by pushing through the *Sarbanes-Oxley* reforms? Some members of the Democratic Party leadership and organized labor would have preferred that Congress *not* passed a corporate governance reform bill in order to keep the issue of financial scandal alive for Democratic candidates in the 2002 mid-term elections. The Democratic leadership agreed to final passage of the *Sarbanes-Oxley Act* out of a combination of idealism and calculation. Sarbanes and a number of allies argued that reform could not be sacrificed for partisan political purposes given the danger the scandals posed to the national and international financial systems. In part, the Democrats chose to pursue good public policy over tactical expediency.<sup>48</sup> They also needed to insulate themselves from charges of obstructionism, however. Had they derailed the reform legislation just prior to the election, the Democrats ran the risk of appearing to play politics with the American economy. Even at the height of the scandals, the Democrats received little credit from the public for their corporate reform efforts (Nagourney, 2002; Dunham, 2002). The corrosive effects of the corporate financial scandals on public confidence fostered an all-embracing public cynicism towards American economic and political institutions and elites that extended to both parties.<sup>49</sup> Either party would have faced intense public hostility, and likely electoral losses if they appeared to have

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<sup>48</sup> In interviews, Republicans as well as Democrats described the motivations for passing the act in these terms. Interviews, Washington, DC, March 2003, March 2004.

<sup>49</sup> See, *e.g.*, Gosselin and Flanigan, 2002 (discussing polls showing plummeting public confidence). Although the Democrats had a slight edge in polls asking which party could best reform business practices, the public's undifferentiated outrage deprived them of the decisive advantage over the Republicans they had expected. As the corporate governance crisis reached its peak, a majority of poll respondents did not believe that legislative reforms would accomplish meaningful change. *Id.*

obstructed reforms or foiled the progress of the legislation(Stevenson and Mitchell, 2002).

## **V. STRUCTURAL REGULATION: THE POLITICS OF CONSTRAINTS AND REGULATORY INNOVATION**

At the height of the corporate governance crisis, interest group politics loosened sufficiently to allow the Democrats to pursue substantial reforms, but two fundamental constraints of partisan politics remained more imposing. The first was the Republicans' intransigence over adding or expanding any new shareholder rights enforceable through litigation. The second was that reforms giving shareholders a more direct and enhanced role in nominating and electing corporate directors were off-limits. Preservation of securities litigation reform was a non-negotiable item for congressional Republicans. It was a "line in the sand" over which they would have killed any reform legislation.<sup>50</sup> Whereas the Democrats were at best ambivalent about securities litigation, the Republicans were almost universally intensely hostile to it. As a result, Sarbanes did not even raise the issue of private causes of action when drafting legislation. Sarbanes' draft legislation never contained new private rights of action. Nor did the legislative debate present a serious effort, let alone a credible threat, of rolling back the 1990s' legacy of restrictions on securities suits. The Republicans did not even have to fight to impose this constraint on corporate governance reform. Even so, Republicans in the House and Senate repeatedly expressed concern over any possible

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<sup>50</sup> Interview, senior Treasury Department official, Washington, DC, March 2004. Sarbanes needed the support of Republican Senator Michael Enzi to report his bill out of committee, and the Democrats knew any attempt to expand the use or availability of private litigation was a "deal killer" for the Republicans. Interviews, Washington, DC, March 2003, March 2004. The one exception was an extension of the statute of limitations for securities fraud claims, which had been substantially shortened by the Supreme Court. This was a controversial issue, but one the Republicans could live with so long as the PSLRA's restrictions remained intact.

increase in securities litigation as a result of corporate governance reform down to the final vote on Sarbanes-Oxley.<sup>51</sup>

Driven by intense and rapidly shifting political pressures for reform, yet still constrained by the anti-litigation politics of the 1990s, the *Sarbanes-Oxley* reforms were effectively forced to experiment with structural regulation.<sup>52</sup> This followed not only from the political logic of the situation, but also from policymakers' practical assessment of the unfolding corporate governance crisis in 2002. Sarbanes and many of the Democratic colleagues believed that this was a structural crisis, rooted in accounting and conflicts of interest, and they would have to fashion a structural solution to it.<sup>53</sup>

*Sarbanes-Oxley* imposed a welter of new regulatory requirements and prohibitions on publicly traded corporations, directors, corporate managers, accountants, securities analysts, and attorneys. This discussion focuses on the most important and innovative provisions (Table 1, below).<sup>54</sup> The most important of these legal changes wrought by *Sarbanes-Oxley* were the creation of the Public Company Accounting Oversight Board (the PCAOB), and the reform of internal corporate board and management structures to institutionalize improved corporate governance within the firm. The PCAOB was a new private regulatory body,

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<sup>51</sup> See, e.g., United States Senate, 2002, vol. 3: 1620-1621 (comments by Sen. Gramm).

<sup>52</sup> Board reform, independent director requirements, and more stringent auditor regulation, all later incorporated into the Sarbanes-Oxley Act, were not themselves new and had been debated at length for many years in academic and policy circles. However, their enactment into law was a fundamentally new step in the politics and the legal framework of corporate governance.

<sup>53</sup> Interviews, Senate Banking Committee staff, Washington, DC, March 2004.

<sup>54</sup> One important regulatory change that does not neatly fit into the scheme of Table 1 and is left out is *Sarbanes-Oxley's* mandatory separation of auditing and consulting services. Although this could be considered a form of structural regulation, it is more accurately described as enforced market segmentation to reduce conflicts of interest.

appointed by and under the oversight of the SEC, charged with regulating the accounting industry.<sup>55</sup> The creation of the PCAOB federalized accounting regulation and displaced the self-regulatory character of the accounting profession and the Financial Accounting Standards Board (FASB) as the primary rule-making body in the fields of accounting and auditing.

**Table 1: Regulatory Features of the Sarbanes-Oxley Act:**

Regulation Type	Provision/Legal Requirement
<b>Regulatory Structure/ Capacity</b>	<ul style="list-style-type: none"> <li>• Public Company Accounting Oversight Board (PCAOB),</li> <li>• Increase in SEC budget.</li> </ul>
<b>Transparency &amp; Disclosure Rules</b>	<ul style="list-style-type: none"> <li>• Heightened disclosure of corporate finances,</li> <li>• Disclosure of “off-balance sheet” transactions,</li> <li>• Disclosure of codes of ethics (and waivers by the board),</li> <li>• Disclosure of reconciliation of “pro forma” financial results with generally accepted accounting principles (US GAAP), and</li> <li>• Real time disclosure of material financial information and developments,</li> <li>• CEO &amp; CFO certification of accuracy of financial reports &amp; adequacy/weakness of internal controls.</li> </ul>
<b>Governmental Enforcement &amp; Sanctions</b>	<ul style="list-style-type: none"> <li>• Increased criminal and civil penalties on executives for disclosure violations,</li> <li>• SEC enforcement of 3<sup>rd</sup> party aiding &amp; abetting liability,</li> <li>• Extension of securities fraud statute of limitations.</li> </ul>
<b>Structural Regulation</b>	<ul style="list-style-type: none"> <li>• Auditing committee comprised <i>entirely</i> of independent directors, Qualified financial expert must sit on audit committee,</li> <li>• Audit committee has direct responsibility for the appointment, compensation, and oversight of the outside auditors,</li> <li>• Audit committee must approve all auditor services,</li> <li>• Auditors must report directly to the audit committee,</li> </ul>

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<sup>55</sup> The creation of the PCAOB was consistent with congressional conservative's preference for private institutions over governmental ones and enabled the new entity to recruit staff from the private sector more effectively by offering salaries far above the civil service scale.



	<ul style="list-style-type: none"> <li>• Compensation committees of independent directors set managerial pay,</li> <li>• Board given legal authority to hire its own counsel and consultants,</li> <li>• Limitations on non-audit services performed by the firm's auditor (and board approval of permitted services),</li> <li>• Develop, implement, and certify adequacy of internal controls,</li> <li>• Whistleblower protections.</li> </ul>
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The more innovative and path-breaking provisions of the *Sarbanes-Oxley Act* are those using structural regulation to intervene in the *internal* structure and affairs of the corporation. Whereas the creation of the PCAOB extended traditional transparency and disclosure regulation to the accounting industry, the structural regulation provisions of *Sarbanes-Oxley* represent a substantial expansion of federal power in the corporate governance area. Although independent auditing committees have been required under New York Stock Exchange listing rules, the *Sarbanes-Oxley* board provisions are the first time that federal law and regulation directly intervened in the composition, structure, and operation of corporate boards.<sup>56</sup> These issues had been within the traditional preserve of state corporation law and the nominally self-regulating stock exchanges. Public firms are now required to appoint an auditing committee comprised *entirely* of independent directors, and at least one member must be qualified as a financial expert under new SEC rules. The audit committee now has direct responsibility for the appointment, compensation, and oversight of the outside auditors. The auditors report directly to the audit

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<sup>56</sup> Federal law had placed some rather minor restrictions on boards, such as the ban on interlocking directorates under the *Clayton Antitrust Act*, but nothing approaching those imposed by *Sarbanes-Oxley*. Likewise, New York Stock Exchange listing rules adopted under SEC pressure had already imposed board independence and committee requirements. However, *Sarbanes-Oxley* was the first time federal legislation directly addressed the subject and, in doing so, strengthened SEC authority and power.

committee, which must resolve any disputes between management and the auditors concerning financial reporting. It must also approve all auditor services. Likewise, the boards of public firms must now put in place independent compensation committees that set managerial pay. *Sarbanes-Oxley* also enhances the more general institutional capacities of the board by giving it the legal authority to hire independent counsel and consultants.

Finally, the law requires CEOs and CFOs to certify that the firm's accounts are accurate and in compliance with accounting rules. Section 404 of *Sarbanes-Oxley* also requires that CEOs certify the firm's internal monitoring and risk management systems as adequate to prevent accounting manipulation and fraud. In practice, this provision compelled the thoroughgoing restructuring of intra-firm managerial, monitoring, and reporting structures and practices.<sup>57</sup> Taken together, these provisions have imposed unprecedented federal regulatory control over the inner workings of the public corporation.

By encroaching on the traditional subjects of state corporate law, the *Sarbanes-Oxley* reforms centralized and federalized key aspects of corporate governance. This unprecedented federalization of corporate law represents a departure from nearly two centuries of American federalism and left largely in place even at the zenith of the New Deal.<sup>58</sup> This break with such a long-established allocation

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<sup>57</sup> No provision of the *Sarbanes-Oxley Act* has sparked more criticism than the Section 404 internal risk management certification provisions. Ironically, this provision has also been a boon to the accountants, who had to audit, assess, and sometimes consult on the design of risk management systems. The law that targeted the accounting industry has in at least one way enriched it significantly.

<sup>58</sup> Despite numerous critics who have asserted that *Sarbanes-Oxley* did not substantially alter the legal terrain of corporate governance (*e.g.*, McDonnell, 2003), others have emphasized the importance of this change in the scope and balance of federal authority. *See, e.g.*, Karmel, 2004 (former SEC commissioner); Chandler and Strine (Delaware Chancery Court judges).

of policymaking power indicates both the growing practical import and policy salience of corporate governance issues, along with the extraordinary political impact of the financial and governance scandals during 2001-2002 (Cioffi, forthcoming; Romano, 2004). Together, these regulatory reforms represent not only a potentially vast expansion of federal regulatory power, but also a substantial centralization of regulatory authority. Federal law and regulation have begun to displace traditions of federalism and the private managerial autonomy that had characterized much of American corporate governance. *Sarbanes-Oxley* thus represents both a stunning reversal of the anti-regulation agenda of the 1990s and a continuation of the skepticism towards private litigation as a mode of regulatory enforcement. The result was an innovative expansion of structural regulation.

Members of Congress were aware of the innovative nature of the corporate governance reforms. They were also aware that the use of structural regulation afforded them a solution the problem of enforcement as well as the rapidly eroding legitimacy of American corporate governance institutions. As one congressional staffer described it, these structural fixes would be “self-executing” with no need (or option) for litigation.<sup>59</sup> The operation of the institutional arrangement itself would be the enforcement. Congress was also cognizant of its deviation from well-worn customs of federalism that allocated corporate law to the states. Indeed, Oxley discussed the issue with his staff repeatedly.<sup>60</sup> However, even a majority of Republicans believed that the securities markets, and thus corporate governance framework that underpinned them, were pre-eminently national in scope and importance.<sup>61</sup> Federalism was again jettisoned when it got in the way of practical politics.

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<sup>59</sup> Interview, Washington, DC, March, 2004.

<sup>60</sup> Interviews, Washington, DC, March, 2004.

<sup>61</sup> *Id.*

The importance of structural regulation and board reform implicates the second powerful political constraint on the politics of corporate governance reform. Despite the significance and sweep of the reforms, *Sarbanes-Oxley* did not reform how directors are nominated and elected. The Act left the very foundation of corporate governance and managerial power under the control of managers. In a statute that relies to such a degree on structural regulation utilizing board independence, this is a striking omission. There are only intermittent references to the subject in the legislative record. Surprisingly, given its importance, there were but a few passing witness statements on the subject.<sup>62</sup> Congressional Democrats were almost entirely silent on the matter.<sup>63</sup> Representative John LaFalce, then the ranking Democratic member of the House Finance Committee and a fierce critic of managerial abuses, merely noted that Congress did not have address the issue because the SEC was empowered to adopt rules governing the nomination and election of directors.<sup>64</sup> Yet during this period the Democrats were attacking the SEC under Chairman Pitt as ineffectual and resistant to substantial reform. The subject of board nominations and elections was simply too explosive to handle.<sup>65</sup> Any attempt to reform board nomination and election rules would have mobilized the American managerial elite against the Democratic Party and shifted its support even more disproportionately towards the GOP. Because the Democratic Party has become increasingly reliant on the support of at least sections of the managerial class, this threat precluded a fundamental challenge to the institutional bases of its power.

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<sup>62</sup> See United States Senate, 2002, vol. 2: pp. 1010-1011, 1026 (comments by Sarah Teslik, Executive Director, Council of Institutional Investors).

<sup>63</sup> Interviews with congressional staff confirm that the issue did not come up in internal committee or partisan debates over the reform legislation. Interviews, Washington, DC, March, 2004.

<sup>64</sup> U.S. House of Representatives, 2002a: p. 55 (comments by Rep. LaFalce). However, LaFalce's bill, voted down by the House, did contain a provision requiring a nominating committee comprised entirely of independent directors.

<sup>65</sup> This assessment was confirmed by a former senior Republican congressional aid. Email communication, February 1, 2005.

Moreover, Sarbanes' priority was to pass the best bill possible under the circumstances. Prior to the WorldCom scandal, it was not clear that Sarbanes would even get his bill out of committee, let alone passed by the full Senate, reconciled with the House bill, and signed by President Bush. If a litigation provision would have killed it, so too would a foundational reform of the corporate power structure.

## **VI. THE BUSINESS BACKLASH: RETURN TO POLITICS AS USUAL?**

### **A. THE BACKLASH BEGINS**

Ultimately, the SEC, under the Chairmanship of Pitt's successor, William Donaldson, advanced a rather weak proposal to reform corporate proxy voting on board nominations and elections in October 2003. This proposal triggered a backlash by business against *Sarbanes-Oxley* and the regulatory reforms that followed it that vindicated the Democrats' reluctance to address the issue in the first place.<sup>66</sup> This backlash and the election of November 2004 would bring the post-Enron reform era to an effective end. The *Sarbanes-Oxley* reforms were the product of exceptional, and by definition temporary, circumstances that short-circuited interest group and institutional politics as usual. With the ebbing of the corporate governance crisis, the dynamics and interest group balances of "normal" politics was restored. (*Cf. The Economist*, July 15th 2004)

The business backlash had been simmering almost since the passage of the *Sarbanes-Oxley Act*. Three general factors

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<sup>66</sup> Legal scholar Mark Roe (1998) has written about "backlash" politics against business caused by left-wing or populist mobilization against financial and corporate interests. But backlash can work in the other direction, especially in a political system, such as that of the United States, where business and financial elites wield so much power and influence. This was the case as business interests pushed back against corporate governance reform during 2003-2004.

contributed to the backlash: (1) the perceived burdens of the new law and regulations, (2) managers' hostility to regulatory constraints on their autonomy, and (3) the balance of partisan politics at the national level.<sup>67</sup> Less than four months after the passage of the Act, and days after the Republican gains in the 2002 congressional elections, Robert R. Glauber, chairman of the self-regulating National Association of Securities Dealers (NASD), advocated delay in implementing new regulations as he spoke out against "unduly bureaucratic" solutions to securities analyst conflicts of interest on Wall Street and their "onerous" costs to securities industry (White, 2002). By *Sarbanes-Oxley's* first anniversary, one year after the peak of the accounting scandals, a former head of the American Institute of Certified Public Accountants fumed that *Sarbanes-Oxley* represented "the criminalization of [corporate] risk taking, which is the same as criminalizing capitalism."<sup>68</sup>

A growing number of business representatives and neo-liberal commentators had begun to voice what would become an increasingly familiar litany of complaints about reform:

- High compliance costs, including increased audit fees and "directors and officers" (D&O) insurance premiums,
- Reducing the number of qualified people willing to serve on boards,

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<sup>67</sup> The focus of this essay is on federal politics. This neither denies nor denigrates the significant developments in reform and enforcement efforts at the state level. State attorneys general, led by New York State Attorney General Elliot Spitzer, have been increasingly active in these areas and repeatedly have been the first to uncover and remedy an increasingly wide variety of financial improprieties throughout corporate America—often to the acute embarrassment of federal regulators.

<sup>68</sup> Schroeder, 2003 (quoting Robert Elliott, a former KPMG partner and former head of AICPA).

- Discouraging domestic firms from going public and inducing public firms to go private,
- Discouraging foreign firms from listing on American stock exchanges,
- Slowing investment and growth.
- Encouraging excessive risk aversion by management,

With the exception of increased D&O insurance and auditing fees, empirical and anecdotal evidence did not support these criticisms. One leading corporate governance consultant ridiculed the complaints as a bunch of “urban myths,” and Treasury Secretary John Snow dismissed them out of hand.<sup>69</sup> Even the increased auditing fees did not appear to be significant in the broader context of corporate cost structures.<sup>70</sup> Even so, polls of corporate executives revealed growing managerial skepticism and outright hostility towards corporate governance reform and regulation (PricewaterhouseCoopers, 2003).

By mid-2004, the business backlash against corporate governance reforms had gathered momentum (Johnson and Birnbaum, 2004). A proposed SEC reform of proxy rules to give shareholders the (very limited) ability to nominate and elect corporate directors mobilized and intensified a growing managerial backlash against corporate governance reform. The fight over board nominations and elections went to the very core of corporate governance and managerial power in the United States and triggered far fiercer and broader opposition. Because the logic of structural regulation under *Sarbanes-Oxley* depends on improving both the representational and monitoring function of boards, the proposed

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<sup>69</sup> *Id.* (quoting Patrick McGurn of Institutional Shareholder Services).

<sup>70</sup> *Id.*

proxy rule amendments would supply a foundation for the *Sarbanes-Oxley* reforms that they heretofore lacked.

Two other issues were particularly prominent in the increasingly vocal managerial hostility towards reform: (1) the expensing of stock options under newly proposed accounting rules, and (2) the difficulties and expense of complying with the internal control certification requirements of section 404 of *Sarbanes-Oxley*. Neither triggered broad-based resistance to corporate governance reform. Opposition to the mandatory expensing of stock options was concentrated in the high-tech industry—most business interests had long concluded that this battle had been lost and that expensing would come, probably sooner rather than later (*See, e.g.,* Norris, 2004; Spinner, 2003b). Nor are the section 404 internal monitoring requirements of *Sarbanes-Oxley* the stuff of an enduring anti-regulation backlash. Although the costs and burdens of section 404 compliance were and are not trivial, most managers of large publicly traded firms accepted them and many managers saw potential benefits of improved managerial capacity through better internal monitoring. The most politically powerful business interests were therefore not intensely opposed to section 404. Also, now that most of these internal control systems are in place, many of the costs and complaints generated by section 404 will likely diminish (*Cf. Byrnes, 2004; Roberts, 2004a, 2004b; The Economist, 2004b*). Managerial hostility to section 404 remains more pronounced among the managers of smaller public firms, but this does not explain the broader backlash against corporate governance reform. Significantly, neither the SEC nor Congress made any effort to roll back the internal monitoring or certification requirements of section 404. But the SEC's shareholder voting reform proposal was something else entirely.

## B. BACKLASH VICTORIOUS: THE FAILURE OF THE SEC'S SHAREHOLDER VOTING REFORM

Following the passage of *Sarbanes-Oxley*, the SEC under William Donaldson, Harvey Pitt's successor as SEC Chairman, engaged in a historic run of rulemaking. The agency strengthened financial and



proxy vote disclosure, accounting rules, and stock exchange regulation. It extended structural regulation directly to mutual funds in response to a series of fund governance scandals by mandating board independence from fund advisors such as Fidelity, Putnam, and Vanguard by requiring a majority of independent directors on fund boards. The SEC also pushed into the opaque and largely unregulated world of hedge funds by requiring their registration with the agency—eliciting protests that this was the first step towards more comprehensive regulation. Under SEC pressure and with its approval, the stock exchanges further stiffened their listing rules on board independence and use of independent board auditing, nomination, and compensation committees.<sup>71</sup>

None of these initiatives proved as controversial as the board nomination rules proposed by the SEC in October 2003 (Securities and Exchange Commission, 2003b). Earlier, in May 2003, the agency had solicited comments on the subject from “interested parties,” in anticipation of proposing a rule on the subject (Securities and Exchange Commission, 2003a). The reaction was immediate. Hundreds of comments poured in from business groups, professional associations, corporate attorneys and law firms, institutional investment funds, and shareholder advocates. By the time the comment period closed on the proposed rules the SEC had received over *13,000 comment letters*, by far the largest number regarding any rule in the Commission’s history (Securities and Exchange Commission, 2004; Peterson, 2004a).

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<sup>71</sup> Chandler and Strine, both judges of Delaware’s powerful and enormously influential Court of Chancery, note (2002: n.12) that the listing rules are a *de facto* component of federal securities regulation and, increasingly, of the federalization of corporate governance law more broadly. They go on to argue, in the context of a defense of Delaware’s corporation law and doctrine, that *Sarbanes-Oxley* does not expand the SEC’s powers over firms’ internal governance affairs or over exchange listing rules. (*Id.*: n. 57) The statute’s provisions regarding independent directors and board committees, at a minimum, suggest the opposite, but they are correct to raise the question of how far the SEC’s authority now extends.

The proposed proxy rules would have allowed institutional investors access to corporate proxies mailed to all shareholders only after substantial delays and under exceptional conditions. The proposed rules would create a two-step, multi-year process to place shareholder board nominations on the corporation's formal proxy ballots. First, at least 35% of voting shareholders would have to withhold their support for a company's director candidate in an annual board election. If this criterion is satisfied, a group representing at least 5% of shares would be able to nominate and run its own nominee(s) on the corporate proxy the following year. Even then, the proposed rules would allow dissident shareholders to elect no more than a minority of three directors in this fashion. This is almost certainly insufficient to substantially change the functioning of boards and suggests that corporate boards, however restructured, will remain ineffective as checks on managerial power.

The ferocity of opposition to the SEC's rather feeble proposal indicates the extraordinary sensitivity of board nomination and election rules and the strength of the gathering managerial backlash. Whereas divisions enfeebled interest groups and empowered policymakers during the debate over *Sarbanes-Oxley*, they were now far more unified—and polarized. Managers, business groups, and allied organizations attacked the proposed rules as destructive of corporate efficiency and an invitation to public and union pension to use their vast holdings to conduct divisive campaigns and pursue special interest agendas. Both the Business Roundtable and the Chamber of Commerce publicly opposed the rules, with the Chamber threatening to sue if they were adopted. Institutional investors, unions, shareholder and consumer advocates, and a number of state treasurers publicly supported the changes, but some argued that the proposed rules were *too weak* to make a practical difference in who oversees the country's largest corporations (Peterson, 2004a).

The conflict escalated in the run up to the 2004 presidential election. Opponents intensified their attack on the proposed rule while the Bush administration reportedly weighed in against it

behind closed doors.<sup>72</sup> The SEC commissioners themselves split over the issue, with the Democratic and Republican commissioners increasingly bitterly divided at 2-2. Donaldson, denouncing the “escalating, shrill, and fearful rhetoric” of interest group battle, largely sided with the Democrats in support of the rule, but sought a compromise that neither side supported (Johnson, 2004a). By July 2004, Donaldson conceded that the SEC was deadlocked over the board nomination proposal (Labaton, 2004b; Peterson, 2004b). Its fate would turn on the election (Peterson, 2004c).

Proponents of the board nomination reforms saw their last chance for such a fundamental reform slipping away. They knew a Bush-GOP victory would spell the end of the effort. The two Democratic SEC commissioners were due to step down after the election, and would almost certainly be replaced with commissioners less supportive of reform. A Bush victory would also leave the Republicans in the White House and Congress free to more directly attack the proposal. In an unusually vituperative public statement, Democratic Commissioner Harvey Goldschmidt attacked the managers who had fought the proposal to a standstill: “The commission's inaction to this point has made it a safer world for a small minority of lazy, inefficient, grossly overpaid and wrongheaded CEOs...the worst instincts of the CEO community have triumphed” (Peterson, 2004c).

As soon as the November 2004 election ended in a Bush victory and an augmented Republican majority in the Senate, post-mortems for the board nomination proposed started appearing in the news. By January 2005, news items reported that the plan was dead (Peterson, 2004d; Johnson, 2004b). Corporate governance reform reached its high-water mark, and it was left in a structural

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<sup>72</sup> See Labaton, 2004a; *see also* Orol, 2004 (indicating the continuing internal ferment and uncertainty over the final form of the rule at the SEC).

state that preserved the institutional foundations of managerialism. The failure of the SEC's proposal to give shareholders more power to nominate and elect corporate directors brought a brief era of reform to a close. Under intense pressure from administration and congressional conservatives, under fire by business groups, and his reform agenda criticized and blocked by increasingly hostile Republican SEC Commissioners, SEC Chairman William Donaldson faced a deteriorating and untenable political position. He resigned in early June, 2005. Within hours of Donaldson's resignation, President Bush nominated Rep. Chris Cox—the principal author of the original House securities litigation reform legislation in 1995 and a vocal critical of regulation—to replace him. While Donaldson's resignation as Chairman of the SEC formalized the end of the corporate governance era, the Cox nomination underscored the close structural and political connection between legislative curbs on securities litigation and the limits of corporate governance reform.

The failure of the SEC's proxy voting reforms suggests that *Sarbanes-Oxley's* structural components will have a less significant impact on corporate governance and managerial behavior than their proponents hoped for and their critics feared. The benefits of board independence have long been the subject of intense academic debate.<sup>73</sup> A long historical record of lackluster board performance by individuals working part time and with little knowledge of the details of a firm's business has fueled the skepticism of many commentators towards claims that director and board independence would improve governance.<sup>74</sup> Indeed,

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<sup>73</sup> For critical reviews of this literature, see, *e.g.*, Romano, 2004; Bainbridge, 2002.

<sup>74</sup> A sizeable empirical literature, beyond the scope of this essay, casts doubts on the claimed benefits of independent directors. However, it should be noted that these critics assume that behavior patterns are static. Past patterns of conduct predict future ones regardless of contextual and institutional changes. It is quite possible that directors and boards will respond to the recent reforms and the new corporate governance environment by treating the position as more of a real job requiring relevant expertise, greater expenditures of time, and

empowering shareholders through board independence may reinforce the short-termism of American finance and corporate management and serve a primarily *value extracting* function by increasing returns without improving other measures of performance. In retrospect, not only have *Sarbanes-Oxley's* structural reforms run aground politically on the *status quo ante*, they largely followed and reinforced the liberal market trajectory that has long characterized the American political economy and its financial system in particular. (See, e.g., Zysman, 1983: ch. 5) In this sense, the economic criticisms of corporate governance reform are beside the point. The reforms were shaped by political forces, not economic ones, just as politics maintained a flawed corporate governance regime that was so conducive to the financial scandals of the 1990s. These same political forces ultimately undermined the internal logic of structural regulation premised on board independence and shareholder representation. In the end, American managerialism has been modified by reform, yet it has demonstrated its political resiliency.

## VII. CONCLUSION

Viewing the structural logic of securities law and corporate governance reforms stretching from the 1990s to the present, we can trace an enduring shift in American politics and regulatory policy. Hostility towards private litigation may have begun on the Republican right, but it achieved bi-partisan support that placed firm political limits on regulatory policymaking going forward. The problems of enforcement created by this aversion to litigation fostered an accelerating trend towards employing structural regulation that alters the structure of the corporate form and the internal operation of governance practices to address problems of governance. Paradoxically, this emphasis on structural regulation

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independent outside professional advice. Of course, such changes will raise the price of directors' services. Scattered evidence suggests this may be happening in practice.

led policymakers to tinker with some of the most basic and sensitive power relations in any capitalist society in ways that blurred the division between the public and private spheres. However, this blurring of regulation of the structure of the corporate form triggered resistance that revealed the political limits of reform. Even at the height of the corporate governance crisis, the fundamental reform of corporate power structures, such as that implied by the SEC's proxy reform proposal, was politically impossible. By failing to address how boards are actually nominated and elected, the corporate governance provisions of *Sarbanes-Oxley*, which rely so heavily on the independence of directors and board committees, were left with a weak foundation. The true political sensitivity of these structural aspects of corporate and managerial power became apparent in 2003 and 2004 as the SEC set out on its ill-fated effort to reform the rules governing board elections left untouched by Congress in 2002.

The failure of either Congress or the SEC to carry corporate governance reform to its logical conclusion (or where it should have started in the first place) by giving shareholders a meaningful role in nominating and electing directors highlights some basic characteristics of policymaking and reform politics in the United States. First, the very structure of the federal government and pluralist interest group politics makes it exceedingly difficult to pass major reform legislation under ordinary political and economic conditions. Second, crises provide the conditions that allow critics and reformers to break through the bottlenecks and veto points of politics as usual, but only for the usually brief duration of perceived emergency. Accordingly, reform and institutional development proceeds in a pattern of punctuated equilibrium, with periods of sudden, episodic, and crisis-driven reform led by state actors. Third, even under crisis conditions, structural and political constraints on policymaking do not disappear. Markets and the institutions on which they depend may fail, at times spectacularly, but the underlying dynamics of institutionalized interests and political constraints persist. Established patterns of interest group politics usually swiftly reassert themselves. When politicians expect that the enfeebled

condition of interest group politics is temporary, and that interest group politics as usual will soon return, powerful interest groups retain influence. Their most basic interests inform political constraints on policymakers who fear mobilizing a potent constituency on behalf of the opposition. Further, some issues are non-negotiable. Even when interest groups and their political allies are weakened, they will fight fiercely when fundamental interests are at stake. When they are willing to pay the short-term political price of using the machinery of government to block reform, these constraints harden and would-be reformers may not bother to openly challenge them.

Corporate governance reforms in the United States exemplify this pattern of punctuated change within powerful, implicit, and largely unchallenged constraints. Senate Democrats never openly challenged the premises or policy of securities litigation reform or managerial control over board nominations and elections. The reformers on the SEC ran afoul of these constraints. Donaldson and the Democratic SEC Commissioners believed the reform momentum generated in 2001-2002 would persist for years, and gambled that it would permit them to pursue ever more fundamental structural changes. The struggle over the board nomination and election rules illustrates how corporate governance has become an important policy arena and partisan political issue, fought over with the intensity that belies its technical character. It also shows that politics is back to normal.

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